REFINANCING YOUR MORTGAGE

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When you refinance your mortgage, you take out a new home loan and use some or all of the proceeds to pay off the existing one. If you obtain a lower interest rate on your new loan than you had on your old one, you'll be saving money.

When to do it

Generally, there are two good times when it's wise to refinance your mortgage. If you've got an adjustable rate mortgage, one of those times is during periods of rising interest rates. If you refinance to a fixed rate mortgage, particularly to a rate similar to your present low adjustable rate, you'll avoid the higher costs when the adjustable rates start going up.

The other time it's a good idea to refinance is when you'll save money by getting a lower interest rate. In this case, you'll want to make sure that your monthly savings will pay back your refinancing costs while you're still living on the property. If you sell your home before your refinancing has paid for itself, you won't be saving anything.

If you are experiencing cash flow difficulties, you may be tempted to lower your monthly mortgage payments by refinancing to extend the term of the loan. From a savings perspective, this is not a good reason to refinance. Unless you get a lower interest rate on the new loan as part of the bargain, you're not really saving any money; in fact, the reverse will be true. If you extend the term of your mortgage without changing anything else, you might loosen your tight cash flow situation, but you'll actually pay more total interest on the mortgage in the long run.

The cost of refinancing

Your refinancing cost is the total of any points, closing costs, and private mortgage insurance (PMI) premiums that you pay when you take out the new loan. In addition, any lost tax savings must also be regarded as part of the cost of refinancing.

There are times when lenders offer "no points, no closing costs" refinancing deals. Check the terms of the offer carefully to make sure that you understand what's involved.

Points are prepaid fees. One point equals 1 percent of the amount you're borrowing, and any points you're charged are usually deducted from the mortgage proceeds you receive. Mortgage lenders typically charge one point as a loan origination fee. Beyond that, lenders may charge additional points on loans with interest rates below the current market rate. By doing so, the lender makes a little more money up front, and you get a lower interest rate on your mortgage. So, if you're going to stay in your house for a long time and can afford to do so, paying more points in the beginning may get you a better interest rate and save you more money in the long run.

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Your closing costs include a variety of fees, such as an appraisal fee, a title search fee, recording fees, and other fees associated with processing and finalizing your mortgage. If your loan−to−value ratio is greater than 80 percent of the appraised value of your property, you may also be required to carry PMI. The premiums for this insurance usually become a portion of your new monthly mortgage payment and thus reduce your savings from refinancing. In addition, you may discover hidden costs. For example, if you're paying less interest on your new mortgage, you'll have less to deduct on your income tax return. If this makes your tax payments higher, your savings will be further offset.

Once you've determined what your refinancing costs will be, you can then determine how long it will take for your refinancing to pay for itself. To do so, divide the total of the points and closing costs that you paid by the net monthly savings that the new loan provides you. Your net monthly savings will be your interest savings less any PMI premiums and tax advantage losses expressed as monthly figures.

For example, assume you refinanced $200,000. You paid two points and total closing costs of $1,800. You got a great interest rate on the loan, so you'll save $80 a month in interest charges. However, your PMI premiums are now $10 per month higher, and you've lost tax savings of $120 a year, or $10 per month. Your refinancing costs are $3,800−−two points of $1,000 each and $1,800 in closing costs. Meanwhile, your net savings are $60 per month−−$80 per month saved interest less $10 per month increased PMI premiums and $10 per month lost tax savings. If you divide $3,800 by $60, you'll find your refinancing will pay for itself in a little over 63 months.

No cash−out versus cash−out refinancing

No cash−out refinancing occurs when the amount of your new loan doesn't exceed your current mortgage debt (plus points and closing costs). With this type of refinancing, you can typically borrow up to 95 percent of your home's appraised value.

A cash−out refinancing occurs when you borrow more than you owe on your existing mortgage. In this case, you are often limited to borrowing no more than 75 to 80 percent of the appraised value of your property. Any excess proceeds remaining after you've paid off an existing mortgage can be used in any way you see fit, but the best use might be to pay off other outstanding high−interest debt, such as credit card debt.

Cash−out refinancing has certain advantages. The interest rate that you'll pay on the mortgage proceeds will usually be less than the interest rate on the other debts (e.g., car loans, personal loans, credit cards, and even some student loans). Moreover, the interest paid on your refinanced mortgage is generally tax deductible, whereas the interest on consumer debt is not.

There are disadvantages to this approach, too. Your refinanced mortgage is secured by a lien on your home. If you can't make the mortgage payments, the lender can foreclose on your home and sell it to pay the mortgage. Credit card or automobile lenders can't take your house away in this fashion. Moreover, unless you're well disciplined, you could pay off the high−interest (credit card) debt only to run it up again, further damaging your financial position.

If you're going to explore a cash−out refinancing, do it only if all of the following are true:

- Your savings make the refinancing worthwhile, even if it wouldn't give you the chance to repay other debt

- Your savings are "real," due to a lower interest rate or a shorter loan term, and not due solely to tax factors, since tax laws may change
- You're sure that you can afford the new monthly mortgage payment
- You trust yourself (and your spouse) not to run up the repaid debt again

Even if the rate on a new mortgage would be only slightly lower that what you've got now, refinancing is a good idea if your savings will outweigh the costs of refinancing during the time you own the home. If you're unsure how much longer you might live in a particular locale, use recouping your refinancing costs in five years or less as a good rule of thumb.

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